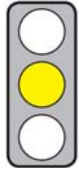


MAIN ISSUES

Objective of the Regulation: The stability of the financial system is to be improved by different regulations for financial service providers and other companies and by differentiating between speculative derivatives and those used to hedge against real corporate risks.

Parties Affected: All companies holding derivatives, notably financial service providers; operators of central counterparties (CCP) and trade repositories.



Pros: (1) The clearing of OTC derivatives through clearing counterparties (CCP) and the planned reporting and risk mitigation requirements can increase the stability of the financial system.

(2) Non-financial institutions could (at least theoretically) be exempted from the Regulation.

Cons: (1) Until further notice, only credit default swaps should be subject to CCP clearing.

(2) It remains to be seen whether a clearly defined distinction between speculative and non-speculative OTC derivatives is possible at all.

(3) In view of the many unanswered questions, the Commission's Report on the systemic relevance of OTC derivatives should not wait until 2014 to be published.

CONTENT

Title

Proposal COM(2010) 484 of 15 September 2010 for a Regulation of the European Parliament and of the Council on **OTC derivatives, central counterparties and trade repositories**

Brief Summary

► Function, relevance and class of derivatives, terminology

- Derivatives are financial contracts whose value is derived from an underlying value. Should a predefined event occur in the underlying contract, partners are entitled to payment or the right to purchase or sell. Derivatives are used for risk hedging or speculative purposes.
- Common derivatives are contracts hedging against interest and exchange rates risks and credit default swaps (CDS). CDS make up 5% of the entire OTC derivatives.
- The contracting parties ("counterparties") are:
 - "financial counterparties": financial service providers (banks, insurance companies, investment firms, UCITS investment funds, hedge and private equity funds and occupational pension funds) or
 - "non-financial counterparties": companies of other industries.
- Less than 20% of derivatives are traded on the stock exchange. More than 80% – mainly non-standardised – are concluded and traded directly between counterparties ("over-the-counter", OTC).

► Reporting and justification requirements for derivatives traded over the counter (OTC derivatives)

- Contracts for OTC derivatives, including possible amendments, must be reported to a registered "trade repository" no later than one day following the contract conclusion. The reports must contain at the very least information on the identity of the counterparties, the class of derivative, the underlying and notional value and maturity. (Art. 6 (1) and (4))
- Reporting requirements apply to:
 - all financial counterparties;
 - non-financial counterparties, provided they have concluded OTC derivative contracts in a volume that exceeds the "information threshold". (Art. 7 (1) in conjunction with Art. 6 (1))
 - The European Securities and Markets Authority (ESMA) will specify information thresholds in the form of regulatory technical standards by mid 2012. Where necessary, the Commission may amend them. (Art. 7 (3) sentence 1 and (5)).
 - Depending on the counterparty and derivative, different information thresholds may apply (Art. 7 (3) sentence 2).
 - Non-financial counterparties must notify the national securities authorities if information thresholds are exceeded and provide justification for their OTC engagement (Art. 7 (1) sentence 1).

► Different treatment of "eligible" and "non-eligible" OTC derivatives

- The Regulation makes a distinction between "eligible" (subject to stricter regulation) and "non-eligible" derivatives (subject to less strict regulation); it does not, however, define them.
- After a public consultation, ESMA decides which OTC derivatives are deemed "eligible". The main criteria for such decisions are the systemic risk of the derivative, its liquidity and the existence of market prices. The Commission may prescribe further criteria. (Art. 4)

► **“Eligible” OTC derivatives: clearing obligation through registered central counterparties (CCP)**

- Clearing obligation: “eligible” OTC derivatives must be cleared through a registered clearing house – so-called “central counterparties” clearing houses (CCP) (Art. 3).
- The clearing obligation applies to (Art. 3 (1)):
 - financial counterparties, provided they have entered into “eligible” OTC derivative contracts with other financial counterparties;
 - non-financial counterparties whose derivative volume exceeds “clearing thresholds”.
 - ESMA will set the clearing thresholds as regulatory technical standards by mid 2012. The Commission may amend such thresholds “where necessary”. (Art. 7 (3) sentence 1 and (5)).
 - In calculating the derivative volume, derivatives that are “objectively measurable as directly linked to the commercial activity of that counterparty” are not taken into account (Art. 7 (4));
 - The derivative volume also includes all “non-eligible” OTC derivatives (Art. 7 (2)).

► **“Non-eligible” OTC derivatives: collateral and capital requirements**

- The credit risk of “non-eligible” OTC derivatives is to be monitored and mitigated by “appropriate procedures and arrangements”. In particular, the following requirements apply (Art. 8 (1)):
 - a daily calculation of the value of outstanding contracts;
 - a “timely, accurate and appropriately segregated” exchange of collateral or
 - an “appropriate and proportionate” holding of capital.
 By mid 2012, the European supervisory authorities (ESMA, EBA and EIOPA) will decide on the levels of the necessary collaterals and the capital required (Art. 8 (3)).
- These requirements apply to (Art. 8 Abs. 1):
 - all financial counterparties;
 - non-financial counterparties whose derivative volumes exceed the clearing thresholds.

► **Authorisation and supervision of CCP**

- Each CCP must have an authorisation issued by the national supervisory authority of the Member State where it is established. Such an authorisation is effective in all EU Member States (“EU passport”). (Art. 10 (2))
- Authorisation requirements are (Art. 12):
 - liquidity: a CCP must have access to central bank liquidity or to credit lines by commercial banks or a combination of the two. A bank authorisation “could” suffice.
 - capital: a CCP must have a “permanent, available and separate initial capital” of at least EUR 5 million and must be able to ensure “an orderly winding-down or restructuring” through their reserves.
- Counterparties from the EU can only clear OTC derivatives through CCP seated outside the EU (third countries) when the said CCP has been recognised by ESMA. The prerequisite for this is that ESMA decides that the relevant supervision is of equal quality (Art. 23 (1)).

► **CCP requirements**

- Members of CCP must deposit “margins” with the CCP as collaterals.
 - The volume of the margins is determined by models authorised by the competent national supervisory authority which capture the risks of a cleared product and the market liquidity (Art. 39 (2)).
 - A CCP can request from its members higher margins on an intraday basis (Art. 39 (3)).
 - Only highly liquid asset values with low credit and price risks may be recognised as collateral. If the risks are too high, haircuts must be applied. ESMA will determine the eligible collaterals and haircuts by mid-2012 (Art. 43).
- Each CCP must establish a default fund from contributions from its members (Art. 40).
 - The default fund must be able to finance the default of the largest clearing member and/or the parallel default of the second and third largest clearing member.
 - The volume of the default fund contributions by members must be proportional to their risk profile.
- If a CCP member fails, the CCP first uses the margins and default fund contributions of that member to cover losses. If this is not enough, it may use the default fund contributions of other non-defaulting members. However, their margins must remain unaffected. (Principle of “default waterfall”; Art. 42)
- CCP must invest their financial resources conservatively in highly liquid instruments with “minimal credit and market risk”. They must avoid any risk concentration with individual obligors. CCP are not allowed to invest in their own securities. ESMA will stipulate the rules regarding acceptable investments and concentration limits by mid-2012. (Art. 44)
- CCP must have enough financial resources to pass a stress scenario in which the two largest CCP members fail. Parental guarantees may be used for this purpose. (Art. 41)

► **Rules of conduct for CCP**

- CCP must treat members and their clients “fairly and professionally in accordance with the best interest”. Their member admission decisions must be based on “non-discriminatory, transparent and objective criteria”. Access may only be denied for risk reasons (Art. 34 and 35).
- CCP must publish prices, fees and their conditions on discounts and rebates (Art. 36).

► Interoperability of CCP

- The interoperability between CCP must be based on an “interoperability arrangement” which is subject to approval by authorities (Art. 50).
- Until further notice, interoperability is admitted only for money market papers and transferable securities (“cash securities”). By 2014 ESMA will submit a report on this subject. (Recital 42, Art. 68 (2))

► Trade repository requirements

- Trade repositories must apply to ESMA for registration which is effective in all EU Member States (EU passport).
- ESMA is the supervisory authority of trade repositories and may impose fines and penalties in the case of infringements. (Art. 51 (1) and 3; Art. 52 (1); Art. 55; Art. 56; Art. 61)
- Trade repositories publish data for all classes of derivatives. Where necessary, they must pass on the “necessary information” to the supervisory authorities and central banks. (Art. 67 (1) and 2)

► Review

By October 2014, the Commission will assess the systemic relevance of OTC derivative transactions through non-financial counterparties in different sectors (Art. 68 (2)).

Changes Compared to the Status Quo

Until now, there have been no European rules regarding OTC derivatives, CCP or trade repositories.

Statement on Subsidiarity by the Commission

According to the Commission, an EU-wide clearing obligation can be achieved only through EU rules. Due to the likely financial impact on Member States in crises, a large part of the supervision of CCP remains with Member States.

Policy Background

The EU Commission has already published two Communications on how to deal with derivatives [Communication COM (2009) 332 of 3 July 2009 and COM(2009) 563 of 21 October 2009, cp. [CEP Policy Brief](#)], in which it proposed improving the collateralisation of derivative transactions and having OTC deals cleared by central counterparties (CCPs) seated in the EU in as standardised a process as possible. With this the Commission follows the G20 decisions of September 2009 (Pittsburgh), which contain provisions on reporting requirements and on CCP clearing obligations for standardised derivatives to be established by the end of 2012. While in March 2010, the European Council called for rapid progress in regulating derivatives, in July 2010 the “Dodd-Frank Wall Street Reform Act” entered into force in the USA, introducing extensive clearing and reporting requirements for OTC derivatives.

Legislative Procedure

15 September 2010	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur: Werner Langen (EEP Group, D); Legal Affairs
Decision mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

Legislative competence:	Art. 114 TFEU (Internal Market; ex-Art. 95 TEC)
Form of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure; ex-Art. 251 TEC)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

Central clearing through CCP can mitigate credit risks and, consequently, **the risks of “eligible” OTC derivatives for the stability of the financial system**. Unlike bilateral clearing between two contract parties, CCPs can clear a multitude of mutual exposures and thus reduce the degree of residual risk.

Limiting the clearing obligation to financial counterparties and to non-financial CCP with very high derivative volumes is appropriate, as it is their losses only that threaten directly the stability of the financial

system. **A general exemption from the clearing obligation for non-financial counterparties would not be a solution**, since financial counterparties could try to forego the clearing obligation through special purpose vehicles.

Whether or not dividing OTC derivatives into two risk classes will be successful, mainly depends on ESMA, which still has to define a number of terms that are still completely open. The same holds true for the attempted balancing act between a more stringent regulation of financial counterparties on the one hand and a reasonable relief of non-financial counterparties on the other hand.

Therefore, of central importance is the question **which OTC derivatives ESMA will categorise as “eligible”** and which, as a result, **will be generally subjected to clearing obligations. CDS should be generally subjected to clearing obligations** due to their high risk potential (see [CEP Policy Brief](#)), **while interest and exchange rate derivatives should not**, unless their systemic risk has been proven. The proposed reporting obligations vis-à-vis trade repositories make sense in order to be able to estimate their systemic risk potential. **Secondly, what will also be decisive is where ESMA sets the clearing threshold** for “eligible” OTC derivatives of non-financial counterparties.

Thirdly, the efficiency of the clearing obligation will depend on which volumes ESMA determines for the – in principle appropriate – capital and collateral requirements for “non-eligible” OTC derivatives, as these derivatives can serve as substitutes for “eligible” derivatives. Here ESMA should accommodate the Capital Requirements Directive (2006/48/EG; see [CEP Policy Brief](#)) that already promotes CCP clearings in that financial institutions do not have to deposit capital for derivatives traded through CCP. Principally justified requirements of the collaterals for “non-eligible” derivatives should take into account that they will raise the costs of risk management in companies significantly.

The obligation of non-financial counterparties to justify their OTC engagement vis-à-vis the national supervisory authority leads to legal uncertainty, as the Regulation leaves completely open as to what form exactly the justification should take and which legal consequences an “inadequate” justification entails.

Moreover, **it is questionable whether supervisory authorities will be able at all to distinguish between speculative OTC derivatives and those serving to hedge real corporate risks.**

However, this distinction forms the basis not only for the burden on non-financial counterparties, but also for the decision on whether or not financial counterparties can forego regulation through special purpose vehicles.

In view of all the outstanding issues, the publication of the Commission’s Report – scheduled for October 2014 – on the systemic relevance of OTC derivatives of non-financial counterparties should definitely be expedited.

With respect to centralising risks with CCP, it is absolutely mandatory to define high margins and to build default funds. The risks and hence the volume of necessary margins should, if possible, be calculated on a daily basis. Given the considerable economies of scale, CCP and trade repositories will be quasi monopolistic. The proposed rules of conduct serve to balance out the resulting disadvantages. Given a lack of experience, the limitation of interoperability to cash instruments is justified for the time being. The EU passport for CCP removes barriers in the internal market.

Impact on Efficiency and Individual Freedom of Choice

The Regulation leads to additional costs for all counterparties due to the reporting and justification obligations, the obligation to clear derivatives through CCP and possible substitutions of “non-eligible” through “eligible” OTC derivatives with the aim to reduce costs. The amount of the additional costs depends on how ESMA sets up the terms and modalities of the Regulation.

Impact on Growth and Employment

An overregulation by ESMA cannot be excluded and would make the risk-hedging of non-financial counterparties more expensive. This ties up capital and reduces growth and the ability to invest.

Legal Assessment

Legislative Competence

The measures serve to foster the proper functioning of the internal market for financial services. To this end, the relevant legislative competence is laid down in Art. 114 TFEU.

Subsidiarity and Proportionality

Unproblematic.

Compatibility with EU Law

Unproblematic.

Conclusion

The clearing of speculative OTC derivatives through central counterparties (CCP) can increase the stability of the financial system. As long as there is no evidence of any systemic risks posed by interest and exchange rates derivatives, only credit default swaps (CDS) should be subject to this clearing obligation. It is questionable whether a clearly defined distinction between speculative OTC derivatives and those serving to hedge real corporate risks is possible at all. In view of the many unanswered questions, the Commission should not wait until 2014 to publish its Report on the systemic relevance of OTC derivatives.